Wilfried
Martens Centre
for European Studies

Coming out of the Shadows: The European Stability Mechanism and Euro Area Governance

Jürgen Matthes

Summary

May 2024

The European Stability Mechanism (ESM) is well suited to having a larger role in the euro area governance framework. During the euro-area debt crisis, financial pressures were eased by ESM loans and many reforms were implemented that targeted former policy mistakes. However, the ESM's public image is tainted due to a political debate that is (unduly) critical of the fact that financial support is conditional on the implementation of reforms. Currently, the ESM lacks the instruments to support countries with relatively sound economic policy fundamentals.

But, an ESM instrument appropriate to this type of support is to be created with an envisaged ESM reform. The reform would introduce a changed precautionary credit line (PCCL). This would provide general access to an ESM loan without the respective country necessarily drawing on it. Such a precaution would be intended to calm the financial markets should they begin to doubt the debt sustainability of a country. The new PCCL would not entail reform prescriptions by the ESM (*ex post* conditionality) but would require sound economic policy fundamentals as a precondition (*ex ante* conditionality).

Choosing to use the ESM is a better way to tackle the current challenges than relying on the European Central Bank with its overly lax Transmission Protection Instrument, as appears to be the current choice. While this instrument might calm financial markets for some time, its overly generous application would reduce incentives for sound economic policy. On top of this, lax reform of the Stability and Growth Pact could also carry the danger that public debts rise further. In the end, this could result in the economic situation deteriorating in a dangerous way. With economic policies diverging widely from the course the euro area governance framework provides for, letting the European Central Bank intervene in the financial markets would be increasingly difficult to justify legally. In this case, the danger of a sovereign default and of an escalating financial crisis in highly indebted countries could loom.

Keywords European Stability Mechanism – Sovereign debt crises – NGEU – Fiscal policy

Introduction

The euro area faces a multitude of simultaneous challenges for fiscal policy and public debt sustainability. The Covid-19 pandemic led to a severe downturn in economic activity and a large increase in public debts. The energy crisis is a less severe, but more permanent burden. With weakened public finances, the euro area member states still need to finance the digital and green transition and higher defence spending. In addition, they have to shoulder higher interest rates and the upcoming demographic challenge which will dampen economic growth and burden public welfare systems.[1]

The EU reacted to the Covid-19 crisis with extraordinary measures, above all, the creation of the NextGenerationEU Fund (NGEU) and the associated extensive transfer payments among member countries. However, in view of the energy price shock and the above-mentioned expenditure needs, the question has arisen of whether additional measures or instruments at the EU level, such as an NGEU 2.0, might be advisable or necessary to ensure that the states retain sufficient fiscal space in view of the foreseeable fiscal burdens. Moreover, there is the possibility of another recession in the near future, further aggravating these challenges.

However, before new support instruments are considered, how far the available financial means suffice and how far existing instruments of the euro area can be of use should be evaluated. In particular, the European Stability Mechanism (ESM) needs to be considered in this respect. The ESM, which currently has an available credit capacity of about €420 billion,[2] is available to the euro area countries. However, some experts consider drawing on this assistance option to be unrealistic, because the ESM is allegedly politically discredited due to the imposition of reform conditionality on aid in formerly vulnerable countries during the euro debt crisis.

[1] This publication is the third in a series of three interdependent papers on the reform of euro area governance. In the first paper, *Reforming Economic and Monetary Union: Balancing Spending and Public Debt Sustainability* (2023), the overarching problem, that the EU is challenged by high government spending demands that collide with already high levels of public debt in many member states and with a worsening outlook for public debt sustainability, is set out. Against this background, the authors evaluate the European Commission's reform proposal for the Stability and Growth Pact and conduct a public debt sustainability analysis showing that a lax fiscal policy stance could lead to a sovereign debt crisis. The second paper, *Reforming Economic and Monetary Union: The ECB's Transmission Protection Instrument* (2023), analyses the pros and cons of the European Central Bank's new Transmission Protection Instrument as a tool to buy the sovereign bonds of distressed countries. It warns that ignoring the conflict between high spending requirements and the risks to public debt sustainability by generously increasing government spending, while using the overly lax Transmission Protection Instrument to tackle the emerging problems in public debt sustainability would be a dangerous and legally problematic strategy.

[2] *ESM*, 'What Is the ESM's Lending Capacity?'

However, this argument is questionable for several reasons from an economic point of view. Establishing the ESM closed a relevant gap in the architecture of the euro area. Before the founding of the European Monetary and Economic Union (EMU), there was a belief that developed countries in Europe could not be in danger of a sovereign debt crisis. This view was proven wrong during the euro debt crisis after 2010. At times contagion effects even affected countries with relatively sound economic fundamentals. Thus, the creation of the ESM as a crisis mechanism became necessary. Cheap ESM loans combined with appropriate economic reforms were able to prevent sovereign debt crises, help rectify former policy shortcomings and create new confidence among financial market actors. Moreover, the responsibility for the continued sustainability of public debts and for the prevention of a sovereign debt crisis clearly lies with fiscal policy and democratically legitimised institutions such as the ESM, not with the European Central Bank (ECB).

In this policy brief, it is argued that the ESM should get back on stage, based on an already envisaged reform of the ESM Treaty. To set the scene, the first section takes a brief look back at the performance of the ESM and the programme countries during and after the euro debt crisis. Based on this, the envisaged ESM reform and its high relevance are highlighted in the second section, particularly with regard to a new ESM programme that is well suited to the current economic situation and that would give the ESM a more benign face. Based on this, in the final section it is argued that the ESM, rather than a potential NGEU 2.0, is well placed to support countries with the challenge of squaring the circle of high spending needs and elevated debt levels.

Looking back: How did the ESM fare?

The ESM is a kind of lender of last resort for euro area countries. As an intergovernmental organisation based in Luxembourg, it has the mission of helping euro area countries to avoid or overcome financial crises by providing financial assistance to member states in case of severe financial distress—for example, should they be unable to refinance their government debt in the financial markets at sustainable rates. The ESM finances the loans to distressed countries not with taxpayer money but with its own loans taken out on the financial market by selling the ESM securities it issues.[3]

[3] *ESM*, 'Who We Are'.

The ESM was developed in several stages:[4]

- Its origins can be found in June 2010 with the establishment of its predecessor, the temporary European Financial Stability Facility (EFSF). The foundation for this first euro rescue fund was laid on a weekend in May 2010 by EU finance ministers when the euro debt crisis was culminating after the first rescue programme for Greece had not sufficiently calmed the financial markets. The Greek Loan Facility included bilateral loans from other euro area countries and from the International Monetary Fund (IMF).

- Ireland and Portugal also experienced sovereign debt crises and followed Greece in requesting EFSF support in February and June 2011, respectively, due to country-specific economic and financial vulnerabilities and also due to contagion effects.

- After a second climax to the crisis during the summer and autumn of 2011, problems spread to Spain and Italy. Italy narrowly escaped having to apply for a rescue programme but the crisis led to the fall of the Berlusconi government, which was replaced by a technical government under Mario Monti. Spain tried to avoid requesting support for some time, but continued to suffer from a real-estate and banking crisis due to the bursting of the property bubble.

- Greece needed a second support package from the EFSF in the course of its sovereign debt restructuring in March 2012.

- In October 2012 the temporary EFSF was replaced by the permanent ESM, established through an intergovernmental treaty among its member states.

- Shortly after this, Spain entered into a three-year programme in December 2012, but only for its financial sector. The ESM mainly provided loans to Spain to recapitalise several severely affected Spanish banks. In early 2013 Cyprus entered into a full programme.

- Greece required a third rescue package in 2015, this time under the ESM, and also received debt-relief measures in 2017 and 2018, mainly consisting of a deferral of interest payments and a significant extension of repayment schedules.

[4] *ESM*, 'History'; J. Matthes, The Euro Rescue Fund @5: Taking Stock, IW Policy Paper no. 11 (Cologne, 2015).

- In spring 2020, during the Covid-19 crisis, another temporary ESM instrument, the Pandemic Crisis Support (PCS), was set up. This programme differed in key aspects from the previous ones, mainly because it could be accessed without any preconditions and without reform conditionality: it was only required that the loan would be used on public expenditure to address the pandemic. However, the PCS programme was never used and was closed at the end of 2022.

One reason why the PCS was not used relates to the fact that the ECB also came to the rescue at this time. It intervened in the sovereign debt markets of vulnerable countries with the newly created Transmission Protection Instrument (TPI) in spring 2020.[5] Moreover, shortly after the foundation of the PCS, the decision was taken to set up the NGEU and the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) to support countries to stabilise their economies in the face of the Covid-19 crisis. In contrast to the aforementioned instruments of the ESM, which take an intergovernmental approach, the NGEU and the SURE programme are controlled by the European Commission.

In evaluating the anti-crisis measures of the EU, it must be highlighted that during both the euro debt crisis and the Covid-19 crisis, the EU reacted relatively rapidly to imminent pressures. It introduced significant changes to the economic governance of the euro area, on a partly temporary and partly permanent basis. By such means, and by acting together with the ECB, it was able to prevent a sovereign debt crisis in both cases. During the euro debt crisis, the significant prolongation of repayment schedules for loans from the EFSF and the ESM (in comparison with IMF loans) also proved the flexibility of its policy actions.

Individual reform programmes addressed those former policy shortcomings that had led to grave macroeconomic and fiscal imbalances and thus contributed to improving economic fundamentals. It is true that the economic adjustments fostered by the reform programmes led to certain hardships. However, the reforms were inevitable. For example, a fiscal deficit of 15% of GDP in Greece in 2010 and current account deficits of around 10% of GDP in several vulnerable countries were clearly not sustainable and required significant reforms. Even without the ESM, the countries would have had to have changed course sooner or later.

5 J. Matthes, *Reforming Economic and Monetary Union: The ECB's Transmission Protection Instrument*, Konrad-Adenauer-Stiftung (2023).

As was to be expected with such significant institutional innovations in difficult times, certain problems occurred and not everything happened in an optimal way. Understandably, the reforms that countries had to take met with political resistance. Some governments took relatively large ownership of the reform programmes and used the ESM conditionality to push through changes that would have been barely politically viable in normal, non-crisis times. Other governments, however, regarded the signing of the Memorandum of Understanding (MoU) in which the reform programme was laid down as an intrusion into national sovereignty. They resisted the reform approach and blamed the Troika (i.e. the European Commission, the ECB and the IMF) and other member states for the pressure placed on them to make adjustments—instead of explaining to their electorate that former policy mistakes had to be rectified to improve the country's economic fundamentals. Greece even came close to having to leave the euro area in 2015. Thus, in countries that took less ownership, the image of the ESM was dented.

It has to be acknowledged that the fiscal adjustment requirements appeared too harsh, particularly for Greece, and created too large a drag to allow economic growth.[6] As tax revenues declined more than expected, even more fiscal consolidation became necessary, setting in motion a downward spiral. While it is easy to criticise this in hindsight, it needs to be remembered that the need for deficit reduction was immense at the time of setting up the reform programmes. Moreover, the Greek economy proved to be rather inflexible, for instance compared to the countries in the Baltics, which weathered severe downturns of more than 14% in 2009 during the global financial crisis and recovered much faster. On top of this, the ability of the Greek administration to collect higher taxes also proved inadequate for a long time.

However, after the ESM programmes ended and after having largely implemented their reforms (with significant delays and complications, particularly in the case of Greece), all the recipient countries were able to smoothly return to the financial markets without further assistance. In the following years, economic growth resumed relatively strongly in Portugal and Spain on the back of the reforms. Growth also returned to Greece and Italy (which had shunned an ESM programme), but at significantly lower levels ahead of the Covid-19 crisis in 2020 (Greece's growth is considerably higher now). Several countries have paid back parts of the ESM loans ahead of schedule.

6 ESM, *EFSF/ESM Financial Assistance – Evaluation Report* (2017).

An independent evaluation of all five financial assistance and reform programmes based on expert interviews with respondents from, among others, the ESM and the member states themselves come to similar conclusions.[7] According to this study, the EFSF and the ESM broadly achieved their mandate of safeguarding financial stability by filling the sovereign financing gap and meeting borrowing needs. The initial diagnosis was broadly adequate in terms of identifying key problem fields, and the programmes addressed each country's different needs, even though some measures were not considered entirely essential. In several countries the fiscal and structural reforms led to a resurgence of economic growth and the programmes were regarded as a window of opportunity. However, some countries did not carry out all the planned or useful reforms as the three-year horizon of the programme proved to be too short to address policy shortcomings that were long-standing and deeply rooted. Moreover, as market access came into sight and thus the urgency to reform was reduced, political ownership weakened and more conflicts arose with the Troika. The ESM governance framework worked reasonably well, while political safeguards in the decision-making process hampered efficiency at times.

In summary, the overall approach of the ESM was broadly successful. Thus, from an economic point of view, its founding has been a largely successful institutional innovation in euro area governance. Nevertheless, the ESM currently appears to have been sidelined for political reasons:

- Due to their resentment of the reform conditionality approach, vested interests in several former crisis countries have tainted the ESM's image.
- The European Commission may not be interested in changing this perception, because alternative support instruments such as the NGEU and SURE loans are under its control—in contrast to the intergovernmental ESM.
- It could be argued that a full ESM programme would not be appropriate currently, as euro area countries are not suffering from fiscal or macroeconomic imbalances that are the result of larger policy shortcomings.

However, the ESM also offers alternative credit facilities. Apart from a full programme, there are lighter ESM programmes suitable for less-precarious economic situations. In particular, two precautionary credit lines are of interest. They offer access to loan facilities for up to two years that are not drawn on at the outset but remain at the instant disposal of the respective country. This precautionary approach has the potential to calm the financial markets and prevent the rising interest rates that could result from financial market actors'

[7] Ibid.

nervousness due to potential challenges to public debt sustainability. In case of need, the respective ESM member state can draw on these facilities at any time.

A key aspect of such credit lines is that *ex post* reform conditionality is much less relevant than in a full programme. Instead, the precautionary credit lines are mainly based on *ex ante* conditionality: only countries with relatively sound economic policies are eligible. There are two kinds of precautionary facilities, neither of which have ever been used and nor are they well known:

- the Precautionary Conditional Credit Line (PCCL) for countries with sound economic and policy fundamentals, and
- the Enhanced Conditions Credit Line (ECCL) for countries with somewhat less sound fundamentals.

Both credit lines also require the country involved to sign an MoU in which a certain policy conditionality is laid down, that is, the country has to agree to limited reforms to tackle the economic problems that led to the need for ESM support. However, the conditionality of the precautionary instruments would be much less intrusive than in a full ESM programme. With the ECCL there would be somewhat more intrusion than with the PCCL, for which reform conditions would be very limited. However, even this limited *ex post* conditionality approach is still seen as a political barrier to the use of the ESM.

A still-pending reform of the ESM Treaty intends to change the PCCL in this respect. This would give the ESM a more benign face and open the door to bringing it back onto the political stage. Indeed, the ESM could play an important role in the current very challenging economic situation. Thus, the reform of the ESM is briefly explained below.

The ESM reform

The ESM reform addresses several aspects of the mechanism.[8] In this brief, the focus is on the reform of the PCCL (the ECCL has not been reformed). After explaining the background and details of this part of the reform, the other reform elements are briefly described.

[8] *ESM*, 'ESM Reform Treaty Reform – Explainer'; *ESM*, 'ESM Reform'; J. Matthes, 'Reform des Europäischen Stabilitätsmechanismus – eine Einordnung', *Wirtschaftsdienst* 1/2021, 54–7.

Reformed PCCL with lower conditionality requirements

With the reformed PCCL, there would no longer be the need for an MoU.[9] It would be sufficient for the euro state concerned to meet a list of *ex ante* eligibility conditions and to specify in a *letter of intent* how it would continue to comply with these criteria during the PCCL term. These criteria include, 'as a rule':[10]

- A fiscal deficit of below 3% of GDP, a structural fiscal deficit at or above the minimum benchmark, and compliance with the 60% debt criterion or the 1/20th debt-reduction rule. These quantitative benchmarks would also have to have been met during a track-record period of two years preceding the request for a PCCL.

- In addition, the requesting country should have sustainable government debt, access to international capital markets on reasonable terms and a sustainable external position. It should not be experiencing excessive imbalances or severe financial-sector vulnerabilities.

The eligibility criteria and the letter of intent would be examined by the ESM (the Managing Director) and the European Commission in liaison with the ECB. That the preconditions would continue to be fulfilled during the term of the PCCL would be checked every six months; should the PCCL be drawn on, such a check would be carried out immediately. If a breach were to be found, the credit line would be terminated unless the Board of Directors was unanimously opposed. If credit had already been drawn upon, the interest margin would be increased unless non-compliance was found to be due to events beyond the control of the ESM member.[11]

The quantitative eligibility criteria of the new PCCL have been further specified beyond those of the old (existing) PCCL,[12] which requires respect of the commitments under the Stability and Growth Pact in general terms. However, a sizeable degree of discretion is retained in the new PCCL, as these conditions only have to be met in principle ('as a rule'). Thus, the application of the new PCCL also appears possible in the current situation of increased fiscal deficits due to the Covid crisis, as a result of which countries' fiscal positions have been severely weakened. In fact, the new PCCL is explicitly intended to apply in the event of an adverse exogenous shock outside of the control of an ESM member.[13]

---

9 *ESM*, 'ESM Treaty Reform – Explainer'.

10 Ibid.

11 *ESM*, 'European Stability Mechanism: Guideline on Precautionary Financial Assistance', art. 5.

12 *ESM*, 'European Stability Mechanism: Guideline on Precautionary Financial Assistance', art. 2.

13 *ESM, Draft Guideline on Precautionary Financial Assistance*.

When the PCCL credit is drawn on and activated, the old PCCL provided for a so-called enhanced surveillance procedure,[14] which required the ESM member to take economic policy measures to address potential difficulties—in addition to providing information on the state of the public finances and the financial system, and submitting to intensified economic policy monitoring through regular country missions. With the new PCCL, such enhanced surveillance is only an option ('. . . may in principle . . .'[15]), meaning that *ex post* reform conditionality might not be applied at all.

In summary, access to the ESM is made much easier by foregoing an MoU, introducing the approach of a letter of intent, and reducing the requirement to take economic policy action when a PCCL is drawn upon and the credit actually used. Thus, the reform has the potential to make the ESM more attractive. This is a significant step because the ESM is an important pillar in the architecture of the EMU. Moreover, the *ex ante* conditionality further incentivises compliance with EMU rules.

Additional elements of the ESM reform

Introduction of a fiscal backstop for the European Banking Union

The ESM reform would also introduce a common fiscal backstop for the European Banking Union. After the financial crisis, the Single Resolution Fund (SRF), financed by banks, was established to support banks in crisis under certain conditions. However, in the case of a very large bank or several larger banks in distress, the SRF's financial means might not suffice. In such a situation the reform enables the ESM to extend a credit line to the SRF of up to €68 billion as a last resort. The SRF, that is, the banks that finance the fund, would have to repay the loan over a period of up to three years to ensure that the ESM's fiscal backstop would be neutral in the medium term. In exchange for the introduction of the fiscal backstop, another ESM facility, the Direct Recapitalisation Instrument, would be abolished. Through the use of this instrument, the ESM could become a holder of the distressed bank's equity and thus gain a say in the governance of an ailing bank; this would, however, be a risky approach.

A larger role for the ESM in financial assistance programmes alongside the European Commission

The ESM would also acquire a larger role in future financial assistance programmes, in particular regarding their design, negotiation and monitoring. The ESM would thus become part of the so-called Troika, with the IMF possibly

[14] *ESM*, 'European Stability Mechanism: Guideline on Precautionary Financial Assistance', art. 5.

[15] ibid.

involved in some aspects of assistance programmes but not in others. Thus, the ESM would have to share competences and cooperate with the European Commission and the ECB. For example, the ESM would participate in assessing the public debt sustainability and the repayment capacity of a country that requests a loan. It would also be involved in designing a potential reform conditionality (without IMF involvement) and in monitoring its implementation (with IMF involvement, if possible).

Facilitation of potential sovereign debt restructurings

The ESM reform would also facilitate potential sovereign debt restructurings, which would be a last resort if public debts became unsustainable or if financial assistance and reform measures had not sufficed to achieve this goal. This would happen in two ways. First, the ESM would be able to facilitate the negotiations between the respective member state and the investors holding its sovereign bonds about the extent to which their claims would be reduced in order to ease the state's debt burden. However, the ESM would only come into play if the relevant member state were to actively request its support. As the ESM is a relevant actor in the financial markets with good knowledge and contacts with investors, this could indeed be useful. Second, the ESM reform would make the outcomes of investors' votes on a specific debt restructuring proposal from the relevant member state more reliable in the medium term. Such votes, which are usually needed to implement the restructuring, are based on the rules in the fine print of sovereign bonds and are enshrined in so-called collective action clauses (CACs). CACs imply that if a qualified majority of bondholders (usually two-thirds in value terms) votes in favour of a debt restructuring, the remaining bondholders will be forced to participate as well. CACs are designed to prevent so-called hold-out investors from not participating, which would come at the expense of the participating bondholders.[16]

To mitigate this risk, the euro states have included CACs in the fine print of their new sovereign bonds since the beginning of 2013. However, these CACs require a qualified majority of creditors at two stages—the first at the level of all government bonds and the second at the level of each issuance series of a bond. Voting at the series level offers hold-out creditors the opportunity to buy up a blocking minority of the respective government bond series with a limited investment volume. If hold-outs were to use this strategy to a significant extent, debt restructuring would be seriously complicated or even prevented. Thus, the ESM reform envisages the introduction of so-called single-limb CACs that require only one vote on the level of all sovereign bonds for all series combined. This reform would make sovereign debt restructurings more orderly and predictable.

[16] B. Busch and J. Matthes, *Regeln für Staatsinsolvenzen im Euroraum*, IW-Analysen no. 104 (Cologne 2015).

State of the reform

The reform of the ESM Treaty came about through several important steps that were taken in late 2018, 2019 and 2020. In early 2021, the ESM member countries signed the Agreement Amending the ESM Treaty. However, the reformed Treaty will only come into force when ratified by the parliaments of all ESM members. So far, all ESM members except Italy have done so.

In Italy there is a certain political opposition to taking this step. There are several possible reasons for this. First, the ESM is generally regarded rather critically due to the reform conditionality it imposes. Resistance might also be related to how the reform would facilitate sovereign debt restructurings through the use of single-limb CACs. Also, certain objections to the ESM's common fiscal backstop for the SRF could play a role with regard to the potential fear that Italy might have to pay for other countries' banks. However, Italy's banks, which are supervised by the ECB, had a higher than average non-performing loans ratio of 2.8% of total gross loans and advances than the EU average (1.8%) in the third quarter of 2023, despite a considerable decline in this ratio in recent years. Strategic reasons may also play a role in view of the ongoing reform of the euro governance framework and particularly the Stability and Growth Pact.

This political blockade is unfortunate, as the reform is an important step towards increasing the effectiveness of the ESM and bringing it back onto the political stage with the new PCCL.

Approaches to squaring the circle

The discussion about ESM reform is highly relevant because the ESM could also be used as an instrument to mitigate the trade-off between high spending needs in the EU and elevated public debt levels in some euro area countries (see the introduction). This would be especially relevant if economic shocks or recessions were to further aggravate this challenge and the vulnerabilities of highly indebted countries in the future.

The energy crisis that came on top of the Covid-19 crisis led to demands to establish an NGEU 2.0, that is, further transfers financed by public debt taken out by the EU. European integrationists may favour this approach as they may regard the energy crisis as an opportunity to further deepen European integration by allowing the EU to raise debt in large volumes on a permanent basis. The NGEU 1.0, however, was intended to be a one-time solidarity effort in reaction to the severe and exogenous Covid-19 crisis.

NGEU 2.0 or ESM?

The alleged drawbacks of the ESM can be qualified

The argument for establishing another European transfer instrument in the form of a potential NGEU 2.0 rather than ESM loans rests on the belief that transfers are more attractive than loans from the ESM. One reason for this is that loans further increase the public debt burden of already highly indebted countries. Moreover, proponents of an NGEU 2.0 might argue that the tainted political image of the ESM is an obstacle and that an ESM loan might attach a stigma to the applicant country in the financial markets which could potentially lead to higher interest rate risk premiums. However, these arguments can be qualified by pointing out that the NGEU 1.0 still has a large financing capacity; that the significant critical arguments against the ESM are less relevant, particularly to PCCLs; and that the transfers of a potential NGEU 2.0 also have several notable disadvantages.

In general, it is true that taking out a loan from the ESM raises the public debt level. However, in the case of a PCCL that is not drawn upon, but remains available only as a precaution, this is not the case. Even if a loan is taken out, the interest rate of an ESM loan is usually considerably lower than the interest rate that a highly indebted country in need of ESM support would pay on the financial markets.

The conditionality problem is also less relevant with the new PCCL (if the ESM reform is implemented). The argument about a potential stigma when applying for an ESM programme is somewhat difficult to evaluate. Again, the risk appears to be relatively small with the PCCL as the requirement of having sound economic fundamentals should contain it. Moreover, the opposite might also be the case: the financial market could react positively, that is, by offering lower interest rates, if a country seeks the protection of the ESM, as the probability increases that its economic policy stance remains sound.

The NGEU still has a large financing capacity – and likely will have beyond 2026

The debate about whether additional measures are necessary to support large spending requirements in highly indebted member states needs to consider the remaining financing capacity of the NGEU 1.0.

The volume of funds of the NGEU (with the Recovery and Resilience Facility (RRF) as its main part) that can be used by highly indebted and vulnerable countries is immense. Compared to the US IRA, which offers about $370 billion over 10 years, Italy is receiving a loan and transfer volume of more than €190 billion over 5 years. On average and relative to GDP, this amounts to yearly financing of about 10 times more for Italy than for the US over the 5 years of the NGEU.[17] With the introduction of the REPowerEU programme, support for Italy might even increase somewhat further in volume.[18]

Moreover, much of the financing of the RRF is still outstanding. Overall, more than €500 billion of the NGEU funds are still to be spent in the next few years. As of early January 2024, of the RRF's total volume of €724 billion, only about €214 billion had been disbursed, comprising €137.2 billion in grants and €76.447 billion in loans,[19] leaving its remaining capacity at about €510 billion. Moreover, it currently appears that of that total volume, some €93 billion might not be claimed at all,[20] leaving the remaining capacity at close to €420 billion. However, the remaining €93 billion might be used for other purposes. On top of this, alongside the RRF there are additional smaller components of the NGEU, totalling €807 billion in funds.[21] It is also likely that only a limited share of these additional components has already been disbursed.

What is more, spending of the NGEU 1.0 is unlikely to terminate as formally expected in 2026, as proponents of an NGEU 2.0 tend to argue while also pointing to continuous high spending needs beyond 2026. However, several countries, and in particular Italy, are struggling to spend the available funds in due time. It is a common feature of the EU's Multiannual Financial Framework (MFF) that the spending phase exceeds its time span by several years. This will likely also be the case with the NGEU.

Transfers via an NGEU 2.0 would have shortcomings and problems

The transfers of the NGEU are financed by public debts raised by the EU that will be repaid after 2027 and up to 2058, directly or indirectly by member states. However, it is still unclear exactly how this repayment will be achieved. This approach appears problematic but was accepted as a one-off measure due to the severity of the Covid-19 crisis. It should not be repeated without a dire need based on clear and decisive evidence.

---

17 M. Hüther and J. Matthes, 'Schadet der US Inflation Reduction Act der deutschen Wirtschaft? Ein Einspruch gegen Übertreibungen', *Atlantik-Brücke*.

18 *European Commission*, 'REPowerEU, Affordable, Secure and Sustainable Energy for Europe'.

19 *European Commission*, 'Recovery and Resilience Scoreboard'.

20 *European Commission*, 'Final Overview of Member States' Loan Requests under the RRF' (1 September 2023).

21 *European Union*, 'NextGenerationEU: Use of NextGenerationEU Proceeds'.

Moreover, every EU country will participate in repaying the EU's debts, probably in line with its general share of contributions to the EU's MFF. Thus, the ultimate volume of the NGEU transfers will be much lower than the face value because the future repayment amount will have to be deducted. Thus, even for net recipients, a sizeable part of the transfer is in fact a debt that will raise the public debt burden in the long run. The German Federal Court of Auditors has estimated which countries will likely be overall net transfer recipients and which will be contributors. Spain, Italy, Greece, Poland and Romania will be the largest net recipients, while Germany will be by far the largest net transfer contributing country, followed after a large margin by France, the Netherlands, Belgium and Denmark. This represents a remarkable expression of European solidarity.

However, compared to directly helping countries with vulnerabilities, the NGEU approach is relatively costly. Net contributing countries could easily finance the transfers they receive from their own public budget without the involvement of the EU. The NGEU approach was therefore chosen for purely political reasons, as it appears politically more viable for transfer contributing countries to support EU partners when they also receive EU transfers. However, channelling the transfers via the EU's NGEU involves large administrative efforts and is thus considerably more costly than a solution where only net recipients would receive pure transfers (without any debt).

Political decision-makers in net contributing countries are probably aware that the NGEU approach is costly for their taxpayers in the longer run. Thus, even if the creation of an NGEU 2.0 became possible to further support vulnerable EU countries, the available amounts would likely be considerably smaller than in the NGEU 1.0. Considering that transfer recipients also have to share in the repayment of the incurred EU debts, the actual support volume of an NGEU 2.0 would probably be rather limited and, in the case of a potential economic shock, likely insufficient.

In contrast, an ESM loan for a distressed country does not involve transfers among EU countries (unless the respective country defaults and does not repay the loan, which appears highly unlikely). The financial assistance would be limited to the country in need. Thus, an ESM loan would not only be more targeted but could also involve a considerably larger sum than an NGEU net transfer.

Moreover, the incentives for support-receiving countries to follow a sound economic policy are likely higher with an ESM loan compared to the NGEU approach for several reasons. First, the loan needs to be repaid and this is usually easier with a sound economic policy course. Second, the institutional setting of the ESM—which depends on the ESM instrument used—caters to this. For the new PCCL, the danger that the precautionary credit line would be terminated if the country deviated from a sound economic policy path is meant to achieve this objective. It is true that the NGEU approach, with transfer tranches depending on reaching milestones, also increases the incentive for national policymakers to follow the agreed approach. However, this conditionality is limited and does not extend to broader economic policy.

Finally, it remains to be seen whether the NGEU approach does work as intended. In June 2023, 30.6% of the overall approved fund allocation of the RRF had been disbursed, while only 11% of the agreed milestones had been reached.[22] This is largely due to the agreed and intended pre-financing design of the RRF. However, with 89% of milestones still to be reached, the challenges are large. Moreover, the European Court of Auditors identified an accountability gap and has criticised the European Commission for not sufficiently controlling the surveillance of the RRF's implementation on the ground.[23] Furthermore, Italy has disempowered its national court of auditors in terms of its continuous and detailed control function, leaving only less-intensive controls, occurring at regular intervals, in place.

Choice of ESM instrument: new PCCL or new Stability Fund?

As explained above, the large funds still available under the NGEU 1.0 should provide sufficient fiscal space for those vulnerable countries that are net recipients. Providing even more funds would not be reasonable when it is a challenge to spend the current funds in time. In this respect, it has to be borne in mind that the regular structural funds under the MFF are also available and also have to be spent in an appropriate manner.

However, it cannot be precluded that a recession could occur in a highly indebted country with good economic policy fundamentals. In this case, two problems may occur, for which the ESM could provide targeted support for vulnerable countries suffering from an economic shock beyond their control.

First, financial markets could get nervous and risk spreads on interest rates could rise, meaning that public debt sustainability could be endangered despite

22 European Parliament Think Tank, *Recovery and Resilience Plans in the 2023 European Semester: Progress and Country-Specific Recommendations* (14 June 2023).

23 European Court of Auditors, *Design of the Commission's Control System for the RRF*, Special Report no. 7 (Luxembourg, 2023).

a sound economic policy course.[24] In such a situation, the new PCCL appears to be a suitable tool to help with this. With its two-year duration it is meant to tackle temporary challenges where the likelihood is high that a precautionary instrument will suffice and the credit line does not need to be drawn on.

Second, a recession or another exogenous economic shock could lead to a situation where, even with the NGEU and the MFF, fiscal space might be too limited to counter the recession and to maintain investment in order to meet the above-mentioned spending requirements (see section 1). In this case, the ESM could act as a kind of rainy-day fund with large financial support volumes targeted directly and specifically at the country in need of support. However, the ESM does not have a suitable instrument for countries with sound economic policy fundamentals that need a sizeable loan and where a precautionary approach with a PCCL would not suffice.

For such a situation, the proposal made by two ESM staff members for a new ESM instrument, an ESM Stability Fund, is relevant.[25] They propose the creation of a new loan programme for countries with sound economic fundamentals that face a deeper recession. The approach (which is not sketched in detail) would rely on *ex ante* conditionality with similar conditions to the PCCL, such as the absence of an excessive deficit procedure or an excessive imbalance procedure. If predefined economic indicators (combined with expert evaluation) signalled a deep recession, a loan of up to 4% of the receiving country's GDP could be made available, with a maturity of 10 years and a grace period of 3 years.

[24] Should financial markets get nervous and risk spreads on interest rates rise in vulnerable countries despite them having sound economic fundamentals, the ECB could also help to a limited degree. In principle, the TPI, which allows the ECB to purchase the sovereign bonds of distressed countries under certain conditions, could be used to calm financial markets and prevent a sovereign debt crisis. However, in its current design the TPI is problematic in many respects, e.g. it provides too much discretion to the ECB, could create problematic incentives for economic policymakers, is democratically problematic and might not be legally compatible. Yet, its fundamentally attractive feature is that, like the new PCCL, the TPI also relies on similar ex ante conditions (see *Matthes, Reforming Economic and Monetary Union*), making it suited to the current economic situation where countries are following relatively sound economic policy courses. Thus, the TPI should be reformed. The ECB's support mechanism for distressed countries has to be linked to the ESM, as a democratically accountable institution, with a conditionality that is appropriate to the economic fundamentals and the quality of economic policy. In the current situation, the new PCCL would therefore be appropriate. Thus, the reform of the ESM is also a precondition for reform of the TPI as another important feature of the euro area governance framework.

[25] F. Misch and M. Rey, *The Case for a Loan-Based Euro Area Stability Fund*, ESM Discussion Paper Series 20 (Luxembourg, 2022).

Conclusion

The ESM is well suited to having a larger role in the euro area governance framework in view of the current challenges of large spending needs, dented growth prospects and risks to public debt sustainability in highly indebted euro area countries. The history of the ESM has been broadly successful in economic terms. During the euro area debt crisis, financial pressures were eased by ESM loans and many reforms were implemented that targeted former policy mistakes. As a consequence, the countries in receipt of a full ESM programme were able to smoothly return to the financial market at the end of the three-year duration of the programme, and economic growth resumed for them sooner or later. However, the ESM's public image is tainted due to a political debate that takes an unduly critical view of the combination of financial support and (*ex post*) reform conditionality.

Nevertheless, the ESM currently lacks the appropriate instruments to support countries with relatively sound economic policy fundamentals that do not require *ex post* conditionality. An appropriate ESM instrument is to be created with the envisaged reform of the ESM, which would introduce a (changed) precautionary credit line. This new PCCL relies only on *ex ante* conditionality, that is, sound economic policy fundamentals and a 'letter of intent' declaring that the country is striving to remain on this sound course. The new PCCL would give the ESM a more benign face and could open the door for it to return to the stage of European affairs. However, Italy has still not ratified the reform of the ESM (which also includes some other relevant elements), even though all other ESM member countries have. Thus, Italy should ratify it as soon as possible.

The challenge of large spending needs and endangered public debt sustainability has led to demands for an NGEU 2.0, that is, for even more sizeable EU transfers to vulnerable states. However, the NGEU 1.0 still has an outstanding spending capacity of more than €500 billion for the coming years and, due to spending delays, probably also beyond its time horizon of 2026. Relative to its economic size, Italy will receive NGEU support amounting to on average about 10 times as much as the IRA provides for the US on a yearly basis for the 5 years of the NGEU's duration. Thus, the case for an NGEU 2.0 appears unfounded. However, it cannot be ruled out that a recession or another economic shock might hit a vulnerable country, causing it to become overburdened in fiscal terms. In such a situation, the instruments of the ESM would be more appropriate than an NGEU 2.0 for several reasons, in particular because it can provide support that is more targeted and allows for the provision of larger sums. It is true that an ESM loan would raise the public debt level further, but this is de facto also partly true of the NGEU approach, as EU debts have to be repaid by member countries eventually.

The new PCCL could be an appropriate instrument for a vulnerable country hit by an economic shock, depending on the country's financing needs. With the two-year horizon of a loan facility that is not drawn on at the outset, it intends to stabilise financial investors' confidence and thus tackle the danger of rising risk spreads on the interest rates of sovereign bonds. However, it might be clear from the outset that the precautionary approach of the new PCCL is not sufficient, that is, that the country will need a loan. For such situations, a new ESM instrument is needed. This could be based on a new ESM Stability Fund, as proposed by ESM staff.

If the economic policy fundamentals of the respective country should deteriorate during the course of using one of the two proposed instruments, other ESM programmes would be available with suitable reform prescriptions to tackle the economic policy shortcomings that had arisen.

Referring to the other two papers in this series, choosing to use the ESM is a better option for tackling the current challenges than the relying on the ECB with its overly lax TPI. While the TPI might calm the financial markets for some time, its overly generous application could reduce incentives for sound economic policy. On top of this, lax reform of the Stability and Growth Pact could also carry the danger that public debts rise further. Ultimately, this could lead to the economic situation deteriorating in a dangerous way. With economic policies diverging widely from the course that the euro area governance framework provides for, letting the ECB intervene in the financial markets would be increasingly difficult to justify legally. In this case, the danger of a sovereign default and of an escalating financial crisis in highly indebted countries could loom.

Bibliography

Busch, B. and Matthes, J., *Regeln für Staatsinsolvenzen im Euroraum*, IW-Analysen, no. 104 (Cologne, 2015), accessed at https://www.iwkoeln.de/fileadmin/publikationen/2015/239374/Analyse_Nr_104_Staatsinsolvenzen.pdf on 1 September 2023.

ESM, *Draft Guideline on Precautionary Financial Assistance*, accessed at https://www.esm.europa.eu/sites/default/files/migration_files/20191206_-_draft_precautionary_guideline_-_publication_version.pdf on 1 September 2023.

ESM, *EFSF/ESM Financial Assistance – Evaluation Report* (2017), accessed at https://www.esm.europa.eu/system/files/document/ti_pubpdf_dw0616055enn_pdfweb_20170607111409_1.pdf on 1 September 2023.

ESM, 'ESM Reform', accessed at https://www.esm.europa.eu/about-esm/esm-reform on 1 September 2023.

ESM, 'ESM Treaty Reform – Explainer', accessed at https://www.esm.europa.eu/about-esm/esm-treaty-reform-explainer on 1 September 2023.

ESM, 'European Stability Mechanism: Guideline on Precautionary Financial Assistance', accessed at https://www.esm.europa.eu/sites/default/files/esm_guideline_on_precautionary_financial_assistance.pdf on 1 September 2023.

ESM, 'History', accessed at https://www.esm.europa.eu/about-us/history on 1 September 2023.

ESM, 'What Is the ESM's Lending Capacity?', accessed at https://www.esm.europa.eu/content/what-esm%E2%80%99s-lending-capacity on 1 September 2023.

ESM, 'Who We Are', accessed at https://www.esm.europa.eu/about-us on 1 September 2023.

European Commission, 'Final Overview of Member States' Loan Requests Under the RRF' (1 September 2023), accessed at https://commission.europa.eu/system/files/2023-09/01092023-Final-overview-of-MS-loan-requests-under-the-RRF_en.pdf on 5 September 2023.

European Commission, 'Recovery and Resilience Scoreboard', accessed at https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/disbursements.html?lang=en on 5 September 2023.

European Commission, 'REPowerEU, Affordable, Secure and Sustainable Energy for Europe', accessed at https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/repowereu-affordable-secure-and-sustainable-energy-europe_en on 1 September 2023.

European Court of Auditors, *Design of the Commission's Control System for the RRF*, Special Report no. 7 (Luxembourg, 2023), accessed at https://www.eca.europa.eu/en/publications?did=63634 on 1 September 2023.

European Parliament Think Tank, *Recovery and Resilience Plans in the 2023 European Semester: Progress and Country-Specific Recommendations* (14 June 2023), accessed at https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2023)749781 on 1 September 2023.

European Union, 'NextGenerationEU: Use of NextGenerationEU Proceeds', accessed at https://commission.europa.eu/strategy-and-policy/eu-budget/eu-borrower-investor-relations/nextgenerationeu_en#use-of-nextgenerationeu-proceeds on 5 September 2023.

Hüther, M. and Matthes, J., 'Schadet der US Inflation Reduction Act der deutschen Wirtschaft? Ein Einspruch gegen Übertreibungen', *Atlantik-Brücke*, accessed at https://www.atlantik-bruecke.org/schadet-der-us-inflation-reduction-act-der-deutschen-wirtschaft/ on 1 September 2023.

Kauder, B., Matthes, J. and Sultan, S., *Reforming Economic and Monetary Union: Balancing Spending and Public Debt Sustainability*, Martens Centre (Brussels, 2023), accessed at https://www.martenscentre.eu/publication/reforming-economic-and-monetary-union-balancing-spending-and-public-debt-sustainability/ on 1 September 2023.

Matthes, J., 'Reform des Europäischen Stabilitätsmechanismus – eine Einordnung', *Wirtschaftsdienst* 1/2021, 54–7, accessed at https://www.wirtschaftsdienst.eu/pdf-download/jahr/2021/heft/1/beitrag/reform-des-europaeischen-stabilitaetsmechanismus-eine-einordnung.html on 1 September 2023.

Matthes, J., *Reforming Economic and Monetary Union: The ECB's Transmission Protection Instrument*, Konrad-Adenauer-Stiftung (2023), accessed at https://www.kas.de/documents/252038/22161843/Das+Transmissionsschutz-

Instrument+der+EZB.pdf/a66462fa-0142-02a6-a857-3ab4700e0e7a?version=1.0&t=1688648250751 on 1 September 2023.

Matthes, J., *The Euro Rescue Fund @5: Taking Stock*, IW Policy Paper no. 11 (Cologne, 2015), accessed at https://www.iwkoeln.de/fileadmin/publikationen/2015/238431/5_years_of_euro_rescue_fund_policy_paper.pdf on 1 September 2023.

Misch, F. and Rey, M., *The Case for a Loan-Based Euro Area Stability Fund*, ESM Discussion Paper Series 20 (Luxembourg, 2022), accessed at https://www.esm.europa.eu/publications/case-loan-based-euro-area-stability-fund on 1 September 2023.

About the author

Jürgen Matthes heads the Department for International Economic Policy, Financial and Real Estate Markets at the German Economic Institute (IW), the largest privately financed economic think tank in Germany. Before taking this position in 2015, he held several positions in the IW Köln which he joined in 1995. His economic studies were undertaken in Dortmund and Dublin (1988-1995). Jürgen Matthes has published on a wide range of topics covering EMU, current account imbalances in the euro area, the competitiveness of nations, the pros and cons of globalization, structural economic change, trade policy, and the global financial crisis.

Credits

The Wilfried Martens Centre for European Studies is the political foundation and think tank of the European People's Party, dedicated to the promotion of Christian Democrat, conservative and like-minded political values.

Wilfried Martens Centre for European Studies
Rue du Commerce 20
Brussels, BE 1000

For more information, please visit www.martenscentre.eu.

Internal editor: Eoin Drea, Senior Research Officer
External editing: Communicative English bvba
Typesetting: Victoria Agency
Printed in Belgium by INNI Group

This publication receives funding from the European Parliament.